

The Chair

CABINET ECONOMIC GROWTH AND INFRASTRUCTURE COMMITTEE

**COVERED BONDS REGISTRATION REQUIREMENTS AND
INSOLVENCY PROTECTIONS**

PROPOSAL

- 1 This paper asks the Committee to agree to proposals for a legislative framework for the issuance of covered bonds by New Zealand registered banks. The proposed legislation would amend the Reserve Bank of New Zealand Act 1989 (the Act), the Corporations (Investigation and Management) Act 1989 (CIMA) and the Companies Act 1993.

EXECUTIVE SUMMARY

- 2 Covered bonds are debt securities issued by a financial entity. The key feature of a covered bond is that bond holders have both an unsecured claim over the issuing entity and hold a secured interest over a specific pool of assets, called the cover pool.
- 3 New Zealand banks have been active in issuing covered bonds over the last two years. This has been carried out under contractual arrangements. However, most jurisdictions with banks active in the covered bond market, including Australia, now have a legislative framework for issuance in place. The lack of a legislative framework in New Zealand puts New Zealand issuers at a disadvantage.
- 4 This paper proposes a legislative framework for covered bonds, the purpose of which is to improve financial stability by ensuring that New Zealand banks have effective access to the covered bond market, as a source of long-term relatively stable finance and as an alternative source of bank funding.
- 5 The main problem identified with current arrangements is that there is a lack of certainty over the effectiveness of legal arrangements to segregate cover pool assets from the other assets of an issuing bank. The effectiveness of asset segregation is a key element that investors take into account when investing in covered bonds. The second problem the legislation seeks to address is to ensure that there is an adequate level of independent monitoring of information provided by issuers on cover pool assets.

- 6 The proposal has three main elements:
- a. a requirement that covered bonds issued by New Zealand banks be registered, subject to meeting registration requirements;
 - b. independent monitoring of cover pools by an asset monitor; and
 - c. provisions to amend the Act, CIMA and the Companies Act to clarify the treatment of registered covered bonds in the event of issuer insolvency.

1. BACKGROUND

- 7 A covered bond is a dual-recourse instrument under which bond holders have both an unsecured claim over the issuing bank and hold a secured interest over a specific pool of assets, called the cover pool.
- 8 Covered bonds can be distinguished from senior unsecured debt instruments issued by banks, where the bond holder is simply an unsecured creditor of the bank, and also from residential mortgage backed securities (RMBS), where the bond holder holds a secured interest in the cover pool but has no claim on the issuing bank.
- 9 Covered bonds are common internationally, with total outstanding issuance being in excess of EUR 2 trillion. European issuers are the largest issuers, and covered bonds are one of the larger asset sectors in the European bond market. Increasingly non-European jurisdictions, such as Australia and Canada, have been issuing covered bonds. New Zealand banks have been active in issuing covered bonds over the last two years. Most of these bonds have been issued in European markets, although there has been some issuance in Australasia.
- 10 The purpose of the framework proposed in this paper is to support financial stability by ensuring banks have effective access to the covered bond market. The ability to issue covered bonds can improve financial stability as it gives New Zealand banks access to a large base of long-term investors that is not available for other forms of funding. Further, as a secured debt instrument, covered bonds have proved to be a relatively stable source of funding over the recent period of volatility in financial markets. In particular, covered bonds markets have remained accessible when unsecured wholesale markets have not. In this way the ability of banks to issue covered bonds may reduce the probability of a bank having liquidity problems or failing. Allowing banks to issue covered bonds complements other measures which the Reserve Bank is taking to improve the resilience of banks to financial market volatility, such as requirements for bank to source funding from stable, or long term, sources and enhanced capital adequacy requirements.

- 11 Covered bonds do, however, create some risks for depositors and other unsecured creditors. In particular, as covered bond holders have a security interest over specific assets, the amount of assets available to absorb unsecured creditors' claims in the event of bank failure would be reduced. For this reason, the Reserve Bank has limited, by way of condition on banks' registration, the percentage of assets that a locally incorporated bank may encumber in favour of a covered bond programme.¹ This limit is set at 10% of the bank's asset base. A limit on the amount of covered bonds banks can issue is not considered in this paper, as the Reserve Bank already has the power to impose a limit.

2. PROBLEMS WITH CURRENT ARRANGEMENTS

- 12 New Zealand banks are currently able to issue covered bonds using contractual arrangements (called 'structured' covered bonds). In Europe, covered bonds have been issued under country-specific legislative frameworks for many years. Over recent years, most countries that have banks active in issuing covered bonds have implemented a legislative framework, including Australia. As a result, almost all covered bonds are now issued under the umbrella of country-specific covered bond legislation, which New Zealand does not currently have.
- 13 International investors tend to prefer to invest in covered bonds that are supported by a legislative framework as this provides additional certainty as to the legal status of the bonds. Some investors are prohibited from investing in covered bonds that are not supported by a legislative framework. The lack of a legislative framework for New Zealand issuers is likely to put them at a disadvantage in issuing covered bonds. This is particularly the case with the recent passage of covered bonds legislation in Australia.
- 14 Over recent years there has been a degree of convergence in legislative frameworks applying to covered bonds, although all frameworks need to take account of country-specific features. One of the most important factors investors consider when investing in covered bonds is the degree to which the laws in place in the relevant jurisdiction allow for cover pool assets to be segregated from the other assets of the issuing bank in the event that an issuing bank were insolvent. This segregation is required so that the covered bond investors can effectively enforce their security interest over the cover pool.
- 15 I consider that the main problem under current New Zealand law is that there is a level of uncertainty as to the extent to which cover pool assets will be effectively segregated from the other assets of the issuing banks in an insolvency situation. This uncertainty arises from the provisions of different regimes that may apply to an insolvent bank. These are

¹ The Reserve Bank is planning on extending this requirement to banks which operate in New Zealand through a branch.

the statutory management regime under the Act, which is mirrored in CIMA, and the liquidation regime under the Companies Act. I discuss the source of this uncertainty in more detail below.

- 16 This paper proposes a solution to address this uncertainty. This solution entails registration of covered bond issues, subject to the covered bond issue meeting registration requirements, including provision for the effective segregation of cover pool assets from the other assets of the issuing bank. Registered issues would then be carved out from certain provisions of the statutory management and liquidation regimes.
- 17 It is common in Europe for supervisory authorities to undertake monitoring of covered bond issues. I do not consider that the costs of public supervision in New Zealand would justify the benefits. However, it is important that the legal framework under which covered bonds are issued provides for the production of accurate information on which investors can rely. For this reason I propose that issuing banks be required to appoint an asset pool monitor to covered bond issues. The functions of the asset pool monitor are discussed in part 5 below.
- 18 The rest of this paper discusses the detail of the proposals.

3. REGISTRATION

- 19 I propose that New Zealand banks be required to register covered bonds prior to issuance. Issues will need to be registered at both the programme and series level (referred to as 'issue' herein).² Several other jurisdictions, including the United Kingdom (UK), require registration of covered bonds. Registration is essential to identify the cover pools that qualify for the insolvency protections discussed below. Registration is likely to entail minimal costs for banks.
- 20 An issue will need to meet specified registration requirements (discussed in paragraphs 29-38) at the time of registration and at all times that the issue remains registered. The requirements for registration will be imposed by way of amendment to the Act, with the Reserve Bank being empowered to administer the register, and this register will be publicly available. Should a bank make changes to an issue in a way relevant to the registration requirements, the bank must so notify the Reserve Bank.

² A series of covered bonds is identical in all respects except for issuance date and price. Series are generally consolidated to form a programme, for which offer documents apply.

- 21 In relation to registration, the Reserve Bank will require power to:
- a. specify the process and form of registration;
 - b. determine the information to be provided on application or at any time whilst the covered bonds remain registered;
 - c. set an application fee;³
 - d. determine the information provided on the register.
- 22 Information that is provided to the Reserve Bank to support an application for registration, and that is not required to be on the register, will be confidential.
- 23 It will be important that the Reserve Bank make timely decisions on registration applications and that its decision-making process is transparent. I propose that the legislation provide that the Reserve Bank must either approve or decline, in writing, an application for registration within 60 working days of an application being made. Where the Reserve Bank intends to reject an application for registration, the Reserve Bank must give the applicant at least 10 working days notice of the intended decision and take account of any further information supplied by the applicant. The Reserve Bank and the applicant may agree to extend these timeframes by mutual agreement.
- 24 I propose that the Reserve Bank only be able to remove an issue from the register at such time as all covered bonds under the relevant issue have matured and all obligations to the bond holders have been met. Whilst an issue remains on the register, registration is effective whether or not the registration requirements have been, or are being, met. This will provide investors with the necessary certainty regarding the validity of registration.
- 25 In order to ensure that the legislation does not nullify any contractual arrangements, the legislation will need to specify that bonds issued in contravention of the legislation remain enforceable obligations. They do not, however, qualify for the insolvency protections discussed below.

Registration of asset classes

- 26 It is common in legislative frameworks in other jurisdictions for limits to be placed on the asset classes that are eligible to be in the cover pool. Some submitters on the Reserve Bank's consultation document on covered bonds argued that such asset class restrictions are desirable, as they provide investors with certainty as to the nature of the collateral

³ The Reserve Bank is not currently minded to charge a fee for registration but considers it prudent to retain the power to do so.

underlying their investment. This is important as cover pools are dynamic, that is, over time assets are removed from the cover pool and replaced. However, investor certainty needs to be balanced against the risk that asset eligibility requirements may restrict the types of covered bonds developed and hence restrict capital market development.

- 27 Balancing these two factors, I propose that the legislation allow for the Reserve Bank to register different classes of covered bonds (either at the programme or series level). Classes of covered bonds may either contain no restrictions on the type of asset that may be included in the cover pool, or may provide restrictions on, or define, the assets to be included in the cover pool. The asset class of the particular issue of covered bonds would be included on the register. This would allow issuers the flexibility to opt into covered bonds where the cover pool assets are restricted, should the benefits of this be seen to outweigh the costs.
- 28 It is possible that an asset in the cover pool may later become ineligible under the asset class designation of the particular issue or that a bank transfers an ineligible asset to the cover pool. The legislation will require that an issue of covered bonds must comply with any asset class designation under which it is registered.

Registration Requirements

- 29 I propose the following registration requirements.

Issuer

- 30 Although any entity can issue secured debt, the international covered bond markets are focused on providing bank funding. In many jurisdictions only designated financial firms can issue covered bonds. Further, only large institutions have the capacity to issue covered bonds, because issues are typically large (often in excess of EUR 1 billion) and covered bonds programmes are expensive to set up.
- 31 For these reasons I propose that initially only covered bonds issued by or on behalf of a New Zealand registered bank will be able to be registered. This includes banks that are incorporated in New Zealand or the New Zealand branches of overseas incorporated banks. The requirement needs to extend to bonds issued on behalf of a registered bank, as registered banks often issue covered bonds through a special purpose funding vehicle.
- 32 In the future it may be that the Australasian covered bond market develops in such a way that smaller entities may be able to issue covered bonds as well. For this reason I propose that further allowable issuers be able to be specified by regulation on the recommendation of the Reserve Bank.

Special purpose vehicle

- 33 An essential element to providing certainty as to the treatment of cover pool assets in the event of issuer insolvency is that the cover pool assets are clearly identifiable and can be separated from the other assets of the issuing bank.
- 34 In order to provide for clear identification of cover pool assets, I propose that a requirement of registration be that the cover pool assets be beneficially owned by a special purpose vehicle (SPV) that is a New Zealand registered company.⁴ The SPV may act as trustee in relation to the cover pool assets. The SPV will be required to carry on no other business except that necessary or incidental to guarantee the obligations under the covered bond. This approach is consistent with current commercial practice in New Zealand and provides a cost effective and transparent mechanism to identify cover pool assets. This is also the approach taken in countries with comparable legal systems, such as the UK and Australia.
- 35 At present, for all New Zealand covered bond programmes, the SPV is a New Zealand registered company. It may be in the future that other entity structures may be considered commercially desirable. For example, limited liability partnerships are used in the UK. For this reason, I propose that further allowable entity structures may be specified by regulation, following a recommendation of the Reserve Bank.

Asset pool monitor

- 36 It has become common for legislative frameworks for covered bonds to require the appointment of an asset pool monitor to verify the information on the cover pool assets provided by the issuer. Such a requirement has been implemented in Australia and the UK. Asset pool monitors are standard commercial practice in covered bonds programmes. I propose that the appointment of an asset pool monitor for each cover pool, consistent with the requirements discussed in part 5 below, be a requirement of registration for New Zealand issues.

All other legislative requirements

- 37 The issue and issuer will have to meet any other obligations imposed under the Act relating to covered bonds. This includes obligations imposed under the Part of the Act relating to covered bonds, and any conditions of registration relating to covered bonds imposed under section 74 of the Act.

⁴ The SPV may own the full legal title to some assets but only the equitable title to others.

Any other matters specified in regulation

- 38 In order to ensure that the legislation remains fit for purpose, I propose that additional requirements of registration may be specified by regulation, following the recommendation of the Reserve Bank.

4. INSOLVENCY PROTECTIONS APPLYING TO REGISTERED ISSUES

- 39 The requirements above require that cover pool assets are beneficially owned by a separate legal entity to the bank. However, this is not sufficient to provide certainty as to the treatment of those assets in the event of issuer insolvency, as there is some uncertainty as to how provisions of the statutory management and liquidation regimes may apply to these assets.

Statutory Management

- 40 A bank may be placed into statutory management under the Act in a number of circumstances, including insolvency. Although less likely, a bank may also be placed into statutory management under CIMA. Where a bank is so placed, the management of that bank is vested in the statutory manager. Statutory management raises two potential issues for covered bond holders:
- a. the potential inclusion of the SPV in the statutory management of the bank; and
 - b. the need for the SPV to enforce certain contractual obligations against the bank.

Inclusion of the SPV in statutory management

- 41 A covered bond SPV could potentially be included in the statutory management of the bank if it is considered an associated person of the bank or a subsidiary of the bank.⁵ This is because section 117(1)(a) of the Act (and section 38(1)(a) of CIMA (which relates to corporations generally)) provides that any registered bank, and any associated person of a registered bank, may be placed into statutory management. Under section 117(2) of the Act (and section 38(2) of CIMA) any subsidiary of a registered bank placed into statutory management is automatically so placed, unless declared otherwise.
- 42 The inclusion of the SPV in the statutory management of the bank would be undesirable for covered bond holders as this may restrict their ability to enforce their security interest over the cover pool. Hence, SPV structures are generally designed to minimise the risk of the SPV being considered an associated person or subsidiary of the bank. However, some market participants are uncertain about the effectiveness of such arrangements, and

⁵ Associated person is defined in section 2(2) of the Reserve Bank of New Zealand Act, the relevant requirement is that a SPV will be an associated person of a bank if the bank controls the management of the SPV or the bank owns more than 20% of the shares of the SPV.

avoiding this risk creates costs for the issuing bank, such as the need to outsource key roles. This has discouraged some banks from issuing covered bonds.

- 43 In order to address these issues, I propose legislative amendments in respect of section 117 of the Act and section 38 of CIMA. These amendments would provide that an SPV constituted under a registered covered bond programme could not be included in the statutory management of the bank as an associated person or as a subsidiary of the bank. This amendment would ensure that in the event that the issuing bank failed, the covered bond guarantee can effectively be activated, i.e the SPV can make payments to bond holders as required under the guarantee.
- 44 A similar carve-out from insolvency provisions is achieved in other covered bond frameworks. For example, in Australia the Banking Amendment (Covered Bonds) Bill amended the Banking Act 1959 to provide that cover pool assets will not be available to meet the claims of creditors, other than covered bond-holders, should a bank be insolvent.

Performance of contractual obligations

- 45 When a bank sells cover pool assets to a SPV it often retains certain obligations. The main obligations arise from the following arrangements:
- a. in order to reduce costs the bank usually retains the legal title to mortgage assets with the SPV being the beneficial owner;
 - b. the bank continues to service the cover pool assets, including collecting payments on behalf of the SPV and maintaining loan files, documentation and data;
 - c. the SPV is granted a power of attorney to perfect the legal title to mortgages should a bank default on its obligations to covered bond holders.
- 46 There are various provisions in the statutory management regimes in the Act and CIMA and the liquidation regime in the Companies Act which market participants, and their legal advisers, consider create uncertainty as to the SPV's ability to perfect its title to cover pool assets and take over the servicing of those assets should a bank become insolvent. I do not consider that it is the intention of the any of these Acts to prevent such title perfection, however, in the absence of judicial authority on the matter, there is a degree of uncertainty as to the breadth of the provisions. Hence I propose that the application of these provisions to cover pool assets be clarified. The provisions that may create uncertainty are:
- a. section 122 of the Act and section 42 of CIMA – which provide that, among other things, no person shall, without the consent of the statutory manager, enter into possession of the property of or commence any proceedings against the entity in statutory management;

- b. section 126 of the Act and section 43 of CIMA - that prevent the transfer or removal from New Zealand of any property of the entity in statutory management, except with the consent of the statutory manager;
 - c. section 128(2) of the Act and section 45(2) of CIMA- which provide that no person shall, without consent, act as an agent of an entity in statutory management;
 - d. section 127 of the Act and section 44 of CIMA - that allow the statutory manager to suspend the repayment of any deposit, or the repayment of any debt, or the discharge of any obligation to any person;
 - e. section 248 of the Companies Act – which provides that a person must not commence legal proceedings against a company in liquidation or exercise a right over the property of a company in liquidation without the consent of the liquidator or by order of the court.
- 47 I propose that a new section be inserted into the Act, CIMA and the Companies Act to provide that nothing in these sections shall:
- a. prevent the transfer of legal title to cover pool assets from the issuer of a covered bond to a SPV under a registered covered bond issue that is the beneficial owner of those assets;
 - b. prevent the transfer under contract of any documentation or data relating to cover pool assets from the issuer of a covered bond to a SPV under a registered covered bond issue that is the beneficial owner of the relevant assets;
 - c. prevent the exercise by a SPV under a registered covered bond issue of a relevant power of attorney granted by the issuer in relation to assets of which the SPV is the beneficial owner;
 - d. suspend the discharge of a contractual obligation of the issuer to pay to a SPV under a registered covered bond issue monies collected on behalf of the SPV in relation to cover pool assets;
 - e. prevent the enforcement of any of the above rights.
- 48 Section 271 of the Companies Act provides that where two related companies are in liquidation, the liquidation of the two companies may proceed together if the Court considers this just and equitable. For the avoidance of doubt I propose that an amendment be made to this section to provide that nothing in this section shall allow the liquidation of a company which is a SPV under a registered covered bond programme to proceed in conjunction with the liquidation of any other company. This will provide further certainty that the cover pool assets will not be pooled with the issuer's assets.

5. ASSET POOL MONITOR

- 49 As discussed, the appointment of an asset pool monitor ('monitor') will be a requirement of registration of covered bonds. The role of the monitor will be one of verification. The obligation to appoint a monitor will lie with the entity which either issues or guarantees the covered bond (referred to as the 'issuer' herein). The issuer will be required to ensure that the monitor produces a report on the matters discussed in this section at least twice a year.⁶ The issuer will be required to ensure that this report is provided to the bond trustee and the security trustee.
- 50 It is current commercial practice for the following two tests to be performed in relation to the cover pool assets:
- a. the asset coverage test, which tests that the value of the cover pool assets exceeds the value of the covered bond liabilities plus a buffer when there has been no issuer default;
 - b. the amortisation test, which provides the same test after an issuer event of default.
- 51 I propose that issuers be required to specify an asset coverage test and an amortisation test in programme documentation. The monitor will then be required to verify the arithmetic accuracy of calculations of these tests performed by or on behalf of the issuer.
- 52 In the event of a test failure, the monitor will be required to undertake the test at three month intervals. If the test failure is cured, the frequency of tests reverts to 6 monthly. If the SPV enters receivership or liquidation the monitor will no longer be required to perform the tests.
- 53 To enable the monitor to perform the functions above, I propose that the issuer be required to ensure that a register of the assets contained in the cover pool is maintained. The register must identify each asset in the cover pool, and provide the value of each asset and the total value of the assets. In the event that the covered bond guarantee is activated, the obligation to maintain the register of assets will pass to the SPV. The monitor must verify that the bank maintains the register and that appropriate steps have been taken by the bank to ensure the accuracy of the information on the register.
- 54 The register of assets will also enable verification of whether the cover pool continues to meet the requirements of the asset class designation. Hence, I propose that the issuer ensure that the monitor include such verification in its report.

⁶ The responsibility to pay the asset pool monitor is a matter specified in contract. I understand that the covered bond guarantor (e.g. SPV) is often responsible for this cost.

- 55 The legislation will specify that the monitor would have access to all relevant information to perform the test, including access to the register of assets discussed below.
- 56 If any of the tests specified in this section are not met, the issuer will additionally be required to provide the report of the monitor to the Reserve Bank. The Reserve Bank will be able to request a copy of the report of the monitor from the issuer at any time. All reports supplied to the Reserve Bank must be kept confidential by the Reserve Bank.
- 57 In order to ensure that the role of the monitor can adapt to future commercial developments, I propose that the legislation specify that regulations made on the advice of the Reserve Bank may specify any further matter to be included in the report of the monitor.
- 58 Investors will need assurance that the monitor can provide an unbiased opinion. For this reason I propose that the monitor must be independent of the issuer or any related party of the issuer. The monitor must also be qualified to perform the role. I propose that the monitor must be licensed or registered to provide an issue audit under the Auditor Regulation Act 2011. The Financial Markets Authority is empowered to set minimum standards for licensing under this Act.

6. ENFORCEMENT

- 59 The proposed legislation places a number of requirements on issuers, including the requirements to ensure that: covered bond issues comply with the registration requirements on a continuous basis; cover pool assets are consistent with any asset class designation; a register of assets is maintained; and that certain tests are specified in programme documentation.
- 60 The Reserve Bank will be responsible for enforcement of the obligations proposed in this paper. Given that these will be requirements under the Act, or under regulations made under the Act, the Reserve Bank will be able to use its existing enforcement powers to ensure compliance. In particular, should an issuer fail to comply with a requirement, the Reserve Bank may issue a direction to that issuer under section 113 of the Act that requires the issuer to comply with the Act. Failure to comply with the direction will be an offence under this Act. Section 156AC of the Act sets out the penalty for failure to comply with a direction, being:
- a. in the case of an individual, imprisonment for a term not exceeding 18 months or to a fine not exceeding \$200,000;
 - b. in the case of a body corporate, to a fine not exceeding \$2,000,000.

7. TRANSITION

- 61 Several New Zealand banks have already issued covered bonds. It is my intention that these issues be registered. Registration will be mandatory for three reasons. First, banks are supportive of mandatory registration of all issues; I understand programme documentation has signalled the possible introduction of a legislative framework and contractual terms allow re-issuance of existing bonds should this be necessary to comply with the legislation. Second, covered bond programmes need to be registered as well as individual series. As programmes enable issuance over a number of years, future series of covered bonds may be issued under existing programmes. Third, registration of all issues provides greater visibility as to the level of asset encumbrance by a given bank.
- 62 In order to give issuers time to make any modifications to programme contracts that may be required to be consistent with the requirements of the Act, I propose that existing issues be required to be registered within 6 months from the passage of the Act.

CONSULTATION

- 63 The Reserve Bank undertook two rounds of public consultation in the preparation of these proposals. These were undertaken in October 2010 and December 2011. The proposals in this paper are largely consistent with those consulted on in December 2011. Market participants, including issuing banks, covered bond investors, and interested members of the legal fraternity are strongly supportive of the proposals and would like to see the legislation introduced as soon as possible.
- 64 The Reserve Bank has also consulted the following Government agencies in the preparation of this proposal: The Treasury, the Ministry of Economic Development, and the OEGI. The Department of the Prime Minister and Cabinet and Parliamentary Counsel Office have been informed.

FINANCIAL IMPLICATIONS

- 65 The Reserve Bank intends to fund the costs of this proposal through its Funding Agreement, rather than charging fees. However, it is intended that provision be made in the legislation for the Reserve Bank to charge fees for applications if this is considered necessary in the future.

HUMAN RIGHTS

- 66 It is not considered that the proposals in this paper would be inconsistent with the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993. Officials from the

Ministry of Justice should be able to provide a final view on this once they have considered the LEG draft of the Bill.

LEGISLATIVE IMPLICATIONS

- 67 The proposals in this paper will require the drafting of new legislation. The proposals will require amendments to the Reserve Bank of New Zealand Act 1989, the Corporations (Investigation and Management) Act 1989 and the Companies Act 1993.
- 68 I do not consider that the future passage of the Financial Markets Conduct Bill will alter any of the proposals in this paper.
- 69 The Bill holds a priority of 4 on the 2012 legislative programme [CAB Min (12)7/7 refers].

REGULATORY IMPACT ANALYSIS

- 70 The Regulatory Impact Analysis requirements apply to the proposals in this paper. A Regulatory Impact Statement is attached to this paper.
- 71 The Reserve Bank Banking Oversight Team Manager has reviewed the regulatory impact statement prepared by the Reserve Bank and associated supporting material; and the reviewer considers that the information and analysis summarised in the RIS meets the quality assurance criteria.
- 72 I have considered the analysis and advice of my officials, as summarised in the attached RIS, and I am satisfied that, aside from the risks, uncertainties, and caveats already noted in this Cabinet paper, the regulatory proposals recommended in this paper:
- are required in the public interest;
 - will deliver the highest net benefits of the practical options available; and
 - are consistent with our commitments in the Government Statement on “Better Regulation, Less Regulation”.

PUBLICITY

- 73 The Reserve Bank will keep banks and the investment community informed as to progress with the passage of legislation. The Reserve Bank will issue a press release, and put a notice on its website, when the Bill is enacted.

RECOMMENDATIONS

- 74 It is recommended that, in relation to the legislative framework for covered bonds, the Committee:
- 1 **agree** that New Zealand registered banks be required to register covered bonds before issuance;
 - 2 **agree** that the Reserve Bank maintain a public register of covered bonds issued by, or on behalf of, New Zealand banks and has the power to:
 - a. specify the process and form of registration;
 - b. determine the information to be provided on application or at any time whilst the covered bonds remain registered;
 - c. set an application fee;
 - d. determine the information provided on the register.
 - 3 **agree** that the legislation provide for a timeframe for the Reserve Bank's decisions on registration applications;
 - 4 **agree** that issuers must ensure that registered covered bond issues meet the following registration requirements, on issuance and at all times that the issue is registered:
 - a. the issuer is a New Zealand registered bank;
 - b. cover pool assets are beneficially owned by a special purpose vehicle (SPV) that is a New Zealand registered company, and that carries on no other business except that necessary or incidental to guarantee the obligations under the covered bond;
 - c. the issuer appoints an asset pool monitor for each cover pool to provide a report to the issuer;
 - d. the issue and issuer meets all requirements under the Reserve Bank of New Zealand Act 1989 relating to covered bonds;
 - e. the issue/issuer meets any other requirements specified by regulation.
 - 5 **agree** that covered bonds issued in contravention of the legislation will remain enforceable obligations, but will not qualify for the protections in recommendations 12, 13, and 14;
 - 6 **agree** that the Reserve Bank have the power to register covered bond issues under different asset class designations;
 - 7 **agree** that the legislation requires an issue of covered bonds to comply with any asset class designation under which it is registered;
 - 8 **agree** that regulations may be made under the Reserve Bank of New Zealand Act 1989 to:
 - a. allow entities other than banks to register issues of covered bonds on the register;

- b. allow that the cover pool SPV may be other than a registered company;
 - c. specify matters to be included in the report of the asset pool monitor;
 - d. provide for further registration requirements.
- 9 **agree** that issuers be required to maintain a register of assets, specify an asset coverage test and amortisation test in programme documentation, and provide all relevant information relating to these tests to the asset pool monitor;
- 10 **agree** that the reports of the asset pool monitor will be provided to the bond and security trustee and the Reserve Bank in certain circumstances;
- 11 **agree** that the asset pool monitor must be licensed or registered under the Auditor Regulation Act 2011;
- 12 **agree** to amendments to the Reserve Bank of New Zealand Act 1989 and to the Corporations (Investigation and Management) Act 1989 to provide that the cover pool SPV cannot be included in the statutory management of the issuing bank either as an associated person or as a subsidiary of the issuing bank;
- 13 **agree** to amendments to the Reserve Bank of New Zealand Act 1989, the Corporations (Investigation and Management) Act 1989 and the Companies Act 1993 to provide that nothing in:
- a. section 122 of the Reserve Bank of New Zealand Act 1989 and section 42 of the Corporations (Investigation and Management) Act 1989;
 - b. section 126 of the Reserve Bank of New Zealand Act 1989 and section 43 of the Corporations (Investigation and Management) Act 1989;
 - c. section 128(2) of the Reserve Bank of New Zealand Act 1989 and section 45(2) of the Corporations (Investigation and Management) Act 1989;
 - d. section 127 of the Reserve Bank of New Zealand Act 1989 and section 44 of the Corporations (Investigation and Management) Act 1989; and
 - e. section 248 of the Companies Act 1993;
- shall
- i. prevent the transfer of legal title to cover pool assets from an issuer to a SPV under a registered covered bond issue that is the beneficial owner of those assets;
 - ii. prevent the transfer under contract of any documentation or data relating to cover pool assets from the issuer to a SPV under a registered covered bond issue that is the beneficial owner of the relevant assets;
 - iii. prevent the exercise by a SPV under a registered covered bond issue of a relevant power of attorney granted by the issuer in relation to assets of which it is the beneficial owner;
 - iv. suspend the discharge of a contractual obligation of the issuer to pay to a SPV under a registered covered bond issue monies collected on behalf of the SPV in relation to cover pool assets;
 - v. prevent the enforcement of any of the above rights;

- 14 **agree** to an amendment to the Companies Act 1993 to provide that, despite anything in section 271 of the Companies Act 1993, the liquidation of a bank which has issued covered bonds cannot proceed in conjunction with the liquidation of a SPV under a registered covered bond programme;
- 15 **agree** that existing covered bonds issues be required to be registered within 6 months of enactment of the legislation;
- 16 **note** that the Reserve Bank will be able to use its existing powers of direction under the Reserve Bank of New Zealand Act 1989 in relation to breaches of the requirements above. Failure to comply with a direction is an offence under that Act for which a financial penalty or imprisonment in the case of an individual is possible.

REGULATORY IMPACT STATEMENT

COVERED BONDS REGISTRATION REQUIREMENTS AND INSOLVENCY PROTECTIONS

AGENCY DISCLOSURE STATEMENT

- 1 This Regulatory Impact Statement ('RIS') has been prepared by the Reserve Bank of New Zealand ('Reserve Bank'). It provides an analysis of options to provide legal certainty as to the treatment of covered bonds in the event that a bank that has issued covered bonds is placed into statutory management or liquidated.
- 2 The proposals in this RIS have been subject to public consultation. The Reserve Bank first publicly consulted on the possibility of a legislative framework for covered bonds in October 2010. A second consultation was carried out in December 2011. The banking industry is strongly supportive of the proposals and would like to see legislation introduced as soon as possible. Industry feedback on technical issues has been taken into account in formulating the proposals.
- 3 The Reserve Bank has also reviewed other legislative frameworks and the existing literature on covered bonds in developing the framework. The Reserve Bank has consulted with the Ministry of Economic Development, the New Zealand Treasury, the Financial Markets Authority, the Australian Treasury, ratings agencies and key financial institutions in developing this framework.
- 4 The proposals in the Cabinet paper, to register covered bond issues, and statutory amendments to clarify the law as it relates to covered bonds when a bank is in statutory management or liquidation, are aimed at providing legal certainty. Hence, these proposals will not impose material new costs on business, impair property rights or market competition, or the incentives of businesses to innovate or invest, or override fundamental common law principles. The requirement for covered bond issuers to appoint an asset pool monitor may impose some small additional costs on issuers. This is because, although asset monitors are standard commercial practice, the proposal requires that the asset monitor report on a more frequent basis than is currently the case for some issuers. The frequency of reporting is however consistent with that required in Australia and will provide investors with additional certainty.

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STATUS QUO AND PROBLEM DEFINITION

- 5 Covered bonds are a form of debt instrument issued by banks. New Zealand banks have been issuing covered bonds under contractual arrangements since 2010.
- 6 In a covered bond issuance, the issuing bank provides an unsecured guarantee as to payment of the obligations under the covered bonds and also specifically tags certain assets, called the cover pool, as security for payment of the obligations. For issuance undertaken by New Zealand banks, the cover pool assets have been sold to a separate legal entity, called a special purpose vehicle (SPV), which issues a guarantee as to payment of the bonds, secured against the cover pool assets.
- 7 Covered bonds are a useful instrument for banks to be able to issue as they provide access to an alternative investor base, are typically issued at a longer term than senior unsecured debt and have proved to be a resilient form of funding at times when other funding markets are closed. For this reason, covered bonds can contribute to financial system stability by providing banks with greater certainty as to access to funding.
- 8 However covered bonds do pose a risk to unsecured creditors. This risk arises as the assets to which covered bond holders have a priority right will not be available to unsecured creditors should a bank fail.
- 9 Internationally, legislative frameworks for the issuance of covered bonds are common place and are a pre-requisite for investment for some investors. Australia has recently passed legislation putting in place a legislative framework for covered bonds. The lack of a New Zealand legislative framework is likely to put New Zealand issuers at a disadvantage and may impede New Zealand issuers' access to the covered bond market.
- 10 An important aspect of covered bond programmes is the ability of the cover pool assets to be segregated from the assets of the issuing bank in the event the issuing bank is insolvent. This segregation is essential so that bond holders can enforce their security interest over the cover pool assets. Consultation undertaken by the Reserve Bank has indicated that there is a level of uncertainty as to how certain provisions of the Reserve Bank Act 1989 ('the Act'), the Corporations (Investigation and Management) Act 1989 ('CIMA') and the Companies Act 1993 would be interpreted regarding assets in the cover pool should an issuing bank become insolvent and placed into statutory management or liquidated. This legal uncertainty is likely to impact on both the quantity of covered bonds a New Zealand bank can issue, particularly at times of stress in financial markets, and the price that a bank has to pay.
- 11 The legal uncertainty arises from two main sources:
 - (a) the potential inclusion of the SPV (and hence the cover pool assets) in the statutory management or liquidation of the bank as an associated person, subsidiary or related company;
 - (b) the potential inability of the SPV to take over from the bank the management of cover pool assets, should an issuing bank fail, due to various 'moratorium' provisions in the Acts which prevent individuals from dealing with bank assets.

- 12 This legal uncertainty can only be remedied by amendments to the Act, CIMA and the Companies Act, as these Acts are the source of the uncertainty.
- 13 Additionally, the Reserve Bank considers that the current regime does not provide sufficient certainty as to the independent verification of the information provided by issuers on cover pools. It is common in other legislative frameworks for independent monitoring of cover pools to be required.

OBJECTIVES

- 14 The main objective of the legislation is to provide legal certainty as to the treatment of cover pool assets in the event an issuing bank was to become insolvent. Legal certainty would increase economic efficiency and financial stability as banks would not have to pay an uncertainty premium to obtain covered bond funding and because certainty would improve banks access to covered bonds markets.
- 15 The secondary objective is to improve investor confidence in New Zealand covered bond issues by providing independent verification of information provided by issuers on cover pools.

REGULATORY IMPACT ANALYSIS

Issuance Limit

- 16 Due to covered bonds potentially subordinating the claims of unsecured creditors, in October 2010 the Reserve Bank consulted on an issuance limit for covered bonds. Such an issuance limit was imposed by way of condition of registration on locally incorporated banks in April 2011. This limit restricts the level of covered bond issuance which these banks may undertake to 10% of total assets, with this limit calculated on the value of assets encumbered for the benefit of covered bond holders. The Reserve Bank intends to extend this restriction to banks operating in New Zealand through branches.
- 17 The Reserve Bank considered a range of possible limits, from no limit to a higher limit. The argument in favour of having no limit is that the market, and rating agencies, would effectively discipline banks to not issue too much secured debt. However, the risks of covered bonds may not be apparent until the market is disrupted and hence market discipline may not be effective in benign times.
- 18 Statements by ratings agencies support setting the limit at about 10% of the bank's asset base. Ratings agencies have indicated that the issuance of covered bonds up to this amount is a positive rating factor for the bank as a whole. This is because the benefits of covered bonds, in terms of supporting banks wholesale funding activities, outweigh the risks to unsecured investors.
- 19 A limit of 10% is also similar to the limit set in Australia. The Australian limit is set at 8% at the time of issuance. As the New Zealand limit of 10% applies at all times, our understanding is that banks are managing to an internal limit of around 8% so as not to inadvertently breach the regulatory limit.

Legislative framework

- 20 The proposed legislative framework is aimed at providing certainty that cover pool assets can be effectively segregated from the other assets of the bank, should the bank be insolvent. There are two main elements to the proposal in this respect:
- (i) requirements to ensure the clear segregation of cover pool assets from the bank's other assets (section 1 below);
 - (ii) protection of covered bond issues from various provisions of the statutory management and liquidation regimes (section 2 below).
- 14 The proposal also requires the appointment of an asset pool monitor to provide independent verification of information provided by the issuer (section 3 below).

Section 1: Asset segregation

- 21 In order to ensure that covered bond SPVs, and hence cover pool assets, are not included in the statutory management or liquidation of an issuing bank, the cover pool assets must be clearly segregated from those of the bank.
- 22 There are two elements to asset segregation on which the Reserve Bank has consulted. First whether assets should be segregated by way of sale of the asset by the bank to an SPV or whether a mechanism should be developed to identify cover pool assets which remain the property of the issuing bank (called the integrated option). This point was consulted on in both October 2010 and December 2011.
- 23 Submitters were strongly in favour of requiring that cover pool assets be sold to a covered bond SPV. This is consistent with current commercial practice and consistent with the requirements of the Australian and United Kingdom legislative frameworks. Submitters considered that it would take significant work to develop an integrated option in the New Zealand context, given this would require the development of a legal paradigm that does not currently exist. Even if such an approach was developed, being untested in New Zealand law it would not necessary deliver the necessary certainty.
- 24 The second element considered was whether covered bond issues should be registered or whether a safe harbour would be appropriate. If covered bond issues are registered, the protections from the statutory management and liquidation regimes (see paragraph 20(ii)) would apply to all registered issues. Under safe harbour, issues meeting various statutory requirements would be eligible for the protections from the statutory management and liquidation regimes. The Reserve Bank consulted on this issue in October 2010. Submitters were strongly supportive of registration, in order to provide greater certainty that a particular issue complied with the requirements for the statutory protections. Submitters on the December 2011 consultation document were strongly in favour of registration being mandatory and applying new and existing issues.
- 25 Given the above, the proposal is that covered bond issues meeting certain registration requirements be registered by the Reserve Bank. These requirements would be set by

amendment to the Act, as the Reserve Bank does not have the power to impose these requirements by way of condition of registration. Registration is likely to entail minimal compliance costs for business.

- 26 Registration will apply to both existing issues and new issues. The possible introduction of a registration framework has been well signalled by the Reserve Bank and anticipated by banks. Banks have indicated a preference that existing issues be registered as well as new issues.
- 27 The first registration requirement is that only covered bonds issued by New Zealand banks can be registered. This is because at present only banks have the capability to issue into the covered bond market, as the typical issuance size is in excess of EUR 1 billion. Further the covered bond market as it exists at present is a market for bank funding. However, as this may change in the future the class of issuers who may register covered bonds will be able to be extended by regulation.
- 28 The second registration requirement is that cover pool assets must be held by a SPV that is a New Zealand registered company. Submitters on the December 2011 consultation were in favour of this requirement, as it accords with current practice. However, some submitters argued that the legislation required future proofing in case alternative entity types were considered necessary in the future. For this reason the proposals include a power for regulations to be made to enable other entity types to be eligible to be the covered bond SPV.
- 29 The other registration requirements are the requirement that an asset pool monitor be appointed, discussed below, and a requirement that the issuer otherwise comply with the legislation. The registration requirements may be expanded by regulation.
- 30 Some submitters on the December 2011 consultation argued that the legislation should restrict the assets that may be included in cover pools in order to provide greater investor certainty as to the composition of cover pools. The risk of this is that the asset class restrictions may restrict financial market development. Balancing these issues, the proposal gives the Reserve Bank the power to register covered bonds under different asset class designations. These designations may restrict the assets in a class or provide a class with no restriction on the assets.
- 31 It is proposed that the Reserve Bank have the power to impose a fee for registration of covered bonds. The Reserve Bank considers it unlikely that such a fee would be imposed. If, however, the Reserve Bank did impose a fee, for example if there was a high volume of transactions which put pressure on current RBNZ funding, this is not likely to be a significant cost given the minimal requirements for registration.
- 32 Consultation indicates that banks and the investment community are supportive of the imposition of these requirements. This is because the gain, in terms of greater investor confidence in New Zealand issues, would significantly outweigh any potential compliance costs.

Section 2: Certainty of treatment in insolvency

- 33 In order to remedy the uncertainty as to the treatment of cover pool assets, in the event an issuer is placed into statutory management or liquidated, two sets of amendments are proposed.
- 34 The first set of amendments which is proposed is to amend the Act, CIMA and the Companies Act to provide that a covered bond SPV cannot be put into statutory management or liquidation with an issuing bank by virtue of being an associated person, subsidiary or related party of the issuing bank (this amendment applies to section 117 of the Act, section 38 of CIMA and section 271 of the Companies Act). This amendment would mean that any failure resolution process applying to the bank would not apply to the covered bond SPV.
- 35 One submitter on the December 2011 consultation document considered that the SPV should be deemed not to be an associated person, subsidiary or related company of the bank. We consider this amendment would be too wide. There are a number of powers that the Reserve Bank, statutory manager or liquidator can exercise over entities so related to a bank (such as the power to require certain information be required) which the Reserve Bank considers appropriate to retain.
- 36 In order to ensure that the management of the cover pool assets can pass from the bank to the SPV (or parties it contracts with) in the event of failure of a bank, amendments are proposed to the Act, CIMA and the Companies Act. These amendments would be made by way of the insertion of a new section in these Acts to provide that nothing in section 122, 126, 127, 128 of the Act (and the corresponding sections in CIMA) and nothing in section 248 of the Companies Act shall:
- (a) prevent the transfer of legal title to cover pool assets from an issuer to a SPV constituted under a registered covered bond issue where the SPV is the beneficial owner of those assets;
 - (b) prevent the transfer under contract of any documentation or data relating to cover pool assets from an issuer to a SPV under a registered covered bond issue where the SPV is the beneficial owner of the relevant assets;
 - (c) prevent the exercise by a SPV under a registered covered bond issue of a relevant power of attorney granted by the issuing bank in relation to cover pool assets of which the SPV is the beneficial owner;
 - (d) suspend the discharge of a contractual obligation of the issuing bank to pay to a SPV under a registered covered bond issue monies collected on behalf of the SPV in relation to cover pool assets;
 - (e) prevent the enforcement of any of the above rights.
- 37 Submitters on the December 2011 consultation document were supportive of these amendments. Clauses (d) and (e) have been included following the December 2011 consultation. This is because one submitter considered that there was some uncertainty

as to the treatment of monies collected by the bank, in its role as servicer of the cover pool assets, on behalf of the SPV.

- 38 One submitter considered that amendments should be made to a number of other sections of the Act, which in the main deal with sales at an under-value. The Reserve Bank does not consider that the powers of the statutory manager or liquidator to disclaim sales made from the bank to the SPV at an under-value should be curtailed and hence has not proposed amendments to these sections.
- 39 The Reserve Bank considers that these changes are minor in nature, as they are effectively clarifications of the law. The economic benefit comes from the reduction in legal uncertainty. This is likely to have a modest positive impact on banks' ability to issue covered bonds.

Section 3: Asset pool monitor

- 40 It is proposed that banks be statutorily required to appoint an asset pool monitor to undertake monitoring of cover bond issues for the benefit of investors. Asset pool monitors are a common feature in other legislative frameworks.
- 41 Most submitters on the December 2011 consultation paper were in favour of a mandatory requirement for an asset pool monitor in order to increase investor confidence. Some submitters felt the requirement was unnecessary given that asset pool monitors are standard industry practice. On balance, the Reserve Bank considers that an asset pool monitor is an important part of the framework. Providing the role in legislation allows minimum standards to be set regarding the asset pool monitor.
- 42 Submitters on the December 2011 consultation paper considered that greater clarity was needed as to the role of the asset pool monitor. Submitters considered that the role of the asset pool monitor should be to verify tests specified by and performed by or on behalf of the issuer, as opposed to developing their own tests. The proposals have been amended to clarify this. The role of the monitor is to provide a report which:
- (a) verifies the accuracy of solvency tests undertaken on behalf of the issuer;
 - (b) verifies that the issuer maintains a register of cover pool assets;
 - (c) verifies that cover pool assets are consistent with any asset class designation under which it is registered;
 - (d) provides for any other matter specified in regulations made under the Act.
- 43 The requirements in 42(b) and 42(c) provide additional responsibilities for the asset pool monitor, compared to the status quo. These functions are considered necessary to ensure that accurate records are kept of cover pool assets and to ensure that legislative requirements relating to asset class designations are met.
- 44 Reports of the asset pool monitor are to be provided to the bond and security trustee, as is current practice. Under the proposal the report must be provided to the Reserve Bank if one of the tests in 42 is not met or if the Reserve Bank so requests. The requirement

to provide reports to the Reserve Bank is an extra requirement imposed by this proposal and provides an extra check that issuers are providing accurate information.

- 45 Given that asset pool monitors are standard industry practice, the requirements will impose only minimal additional costs on issuers. One aspect that submitter have commented on is the requirement that the asset pool monitor undertake its test biannually, as opposed to the current annual testing. This is likely to impose some additional cost (our understanding is that the additional cost will be in the order of \$3000-\$5000 per year and will be met by the SPV). The Reserve Bank considers this cost would be justified by the benefit in terms of greater investor confidence in the information provided. Biannual testing is consistent with the Australian legislation.

CONSULTATION

- 46 The Reserve Bank undertook public consultation on the legislative framework for covered bonds in October 2010 and December 2011. The Reserve Bank received 12 written submissions on each consultation document.
- 47 The banking industry is strongly supportive of the proposals for a legislative framework for the issuance of covered bonds, particularly as Australia has recently implemented such a framework. The banking industry would like to see the proposal introduced as soon as possible.
- 48 The main issue that was raised in submissions on the December 2011 consultation document was clarification that the role of the asset monitor is one of verification. As discussed, this has been addressed. Some submitters considered the framework should apply more widely to securitizations in general. The Reserve Bank considers that there are a number of risks with so extending the framework, and so these proposals relate only to covered bonds.
- 49 The Reserve Bank has also consulted rating agencies and key market participants, such as buyers of covered bonds. These entities have indicated that investors have a strong preference for legislatively backed covered bonds.
- 50 The Reserve Bank consulted the Ministry of Economic Development, the New Zealand Treasury, OEGI, and the Australian Treasury in the preparation of this policy.

CONCLUSIONS AND RECOMMENDATIONS

- 51 The main elements of the proposed framework are:
- (i) a requirement that covered bonds be registered on a register maintained by the Reserve Bank;
 - (ii) a requirement that cover pool assets be held by a special purpose vehicle, which is a New Zealand registered company;
 - (iii) a requirement that an asset pool monitor be appointed to undertake certain specified tests on the cover pool assets; and

- (iv) amendments to the Act, CIMA and the Companies Act 1993 to provide certainty as to the application of those Acts to cover pool assets in the event an issuing bank is placed into statutory management or liquidation.

IMPLEMENTATION

- 52 The proposal will be given effect through amendment to the Act, CIMA, and the Companies Act 1993. Existing issues will be required to be registered 6 months after the passage of the legislation. New issues will require registration prior to issuance.
- 53 As the proposal is one of clarification, and is based on existing commercial practice, the Reserve Bank considers that the risks are minor and that there is no impact on the integrity of the statutes being amended.
- 54 As the main objective of the legislation is to provide legal certainty, the proposals will impose only minimal new costs on business, and will not impair property rights or market competition, or the incentives of businesses to innovate or invest, or override fundamental common law principles. Minor additional costs may be imposed due to the requirement that reports of the asset monitor be required to be provided more frequently than is standard practice.
- 55 The Reserve Bank will be able to assess compliance with the requirements through existing supervisory processes.

MONITORING, EVALUATION AND REVIEW

- 56 The policy will be reviewed consistent with the regulatory impact analysis requirements in section 162AB(1)(b) of the Act. The main sources of information the Reserve Bank will rely on to assess the effectiveness of legislation are discussions with supervisory contacts in registered banks which the Reserve Bank supervises, as well as contacts with covered bond investors, ratings agencies and other regulatory agencies.